

Minutes of Teleconference of Task Force B
(July 24, 1997 at 2:00pm, EDT)

I Identified parties present:

Jack Harper, Co-Leader	Roy Crawford, Co-Leader
Harold Aldinger	Stephen Auster
	Tom Bowen
Alan Friedman (Facilitator)	
Jennifer Hayes	Jeff Friedman
Paull Mines (Reporter)	Ted Ghiz
Chuck Redfern	Russ Uzes
John Theis	David Wulf
Brian Toman	

Ed. Note: These minutes do not disclose the identity of specific individuals with respect to recorded discussions. The Reporter has adopted this style, because the underlying assumption of the participants is that no participant should be precluded from free expression. Non-attribution allows all to state their views frankly, because it lessens the threat of being tagged with their own comments that were made in the course of the intended, free-flowing examinations undertaken by the Public Participation Working Groups. Please also note that certain items were identified as being attached to these minutes. The collection of these items produced a voluminous document. Rather than attempt to fax everything to everybody, please call Loretta, (202) 624-8699, if you want any of the following: Cal. Legal Rulings 91-1, 95-7, 95-8, Cal. Statute § 25105, Cal. Reg. § 25137-1.

I No public comments were made.

II At this teleconference meeting, the Task Force discussed the following topics assigned in Dallas—

- ◆ Instant unity;
- ◆ Unity of ownership;
- ◆ Holding companies; and
- ◆ Pass-through entities (partnerships).

The discussion proceeded with the underlying understanding that the Task Force was commissioned to report its progress in Whitefish in early August and that it was not incumbent upon the Task Force to reach final resolution of its assigned issues by that time.

III Instant unity: A tentative consensus developed, subject, however, to one participant's continuing objection to the use of the clear and cogent evidence standard of proof in the regulation. See minutes for Task Force B meeting of July 10, 1997. The Task Force believed there should be the following presumptions in the area of instant unity—

1. There is a presumption against instant unity in the case of acquired corporations for the short reporting period (from date of acquisition to date immediately preceding the group's first full common tax reporting period). However, either the taxpayer or the State can challenge the presumption against instant unity based upon facts and circumstance that establish the existence of unity by clear and cogent evidence. Unity would exist from the point in time that clear and cogent evidence established a unitary relationship existed.
2. There is a presumption for instant unity in the case of a newly formed corporation for the short reporting period (from date of formation to date immediately preceding the group's first full common tax reporting period). However, either the taxpayer or the State can challenge the presumption for instant unity based upon facts and circumstance that establish the non-existence of unity by clear and cogent evidence. A lack of unity would exist from the point in time that clear and cogent evidence established no unitary relationship existed.

The viewpoints that were considered in the development of this tentative consensus included—

1. *Unconstitutionality possible.* There is substantial risk of unconstitutionality if you applied the rule that if a unitary relationship were shown to exist at the end of the short-reporting period a unitary relationship would be deemed to exist for that period. (This rule is sometimes referred to in these minutes as the “unity at the end means unity for all rule.”)
2. *Curing possible unconstitutionality.* To allow the taxpayer to elect to use the “unity at the end means unity for all rule” would cure the constitutionality concern for the taxpayer, but it would create an unlevel playing field for the State that could not impose the same rule on the taxpayer without the taxpayer's specific consent.
3. *Simplifying alternative.* One alternative to the consensus suggested is to have an absolute rule that no acquired company will be treated as having unity with the acquiring companies for the short reporting period.
4. *Simplifying alternative constitutional?* Some questioned whether a State employing unitary-based, combined reporting could constitutionally adopt the alternative rule of #3, that is, deny combined reporting to a corporation that was in fact unitary. Others questioned the questioners, indicating that the Constitution provides limitations not mandates.
5. *Burdensome to split single reporting period.* One participant in the compliance/ filing business indicated there is an extreme burden placed on a company when it must divide its reporting period income and factors according to the temporal point when the company became unitary with the acquiring companies.

6. *Any observations on newly formed entities?* Although not stated during the teleconference, reciprocal observations might be advanced about the newly formed business entity presumption.

VI. **Holding companies:** (This issue arises because a corporation holds stock to one or more operating subsidiaries. The issue does not concern passive investment companies, like Delaware holding companies.) The task force adopted a tentative consensus that the MTC regulation should adopt the PBS approach of the California BOE that is reflected in legal rulings 95-7 and 95-8 of the California Franchise Tax Board, at least so far as these rulings went, i.e., the rulings were limited to a holding company over a single unitary business. Copies of the rulings are attached. This consensus does not resolve all holding company issues. The viewpoints expressed with respect to additional, but unresolved, issues, included—

1. *How to treat a holding company acting with respect to more than one unitary business.* The issue of how to effect the combination of a holding company when the holding company acts with respect to two or more different unitary businesses remains unresolved. (An example is of this circumstances is a passive holding company acting with respect to three different unitary lines of business, A, B, and C.) Some urge an unspecified facts and circumstances allocation of the holding company among the different unitary lines, that is, you divvy-up the holding company as the facts and circumstances permit. (An example is to allocate some of the holding company to line A, some to line B and the remainder to line C.) The parties describing the merits of the divvy-up approach were not enchanted with the dominant corporation concept that was one of the suggestions of CA-BOE in *PBS*. Others more in keeping with the dominant corporation concept indicated that finding a passive holding company unitary with operating subsidiaries is problematical, but still doable, when there is *one* unitary line. When *more than one* unitary line exists, then the necessary exclusivity element cannot be met. Exclusive dedication is necessary to support a finding of contribution and dependency that will support the combination of a passive holding company. Without exclusivity the holding company is not doing very much in an operational sense with the operating companies. This understanding is reflected in *Legal Ruling 95-7* and *Legal Ruling 95-8* that require the holding company to dedicate all or virtually all of its activity, however small, to the unitary operating company or line of companies to support a finding that permits combination.
2. *How to Allocate on facts and circumstances.* Those arguing for an allocation based upon facts and circumstances when the holding company operates with respect to more than a single unitary line still face significant challenges in determining what the facts and circumstances actually permit in any individual case. Divvying-up the holding company among the separate lines of unitary businesses on a facts or circumstance basis presents substantial challenges.

3. *Contentious interest.* The contentious issue of interest paid to third parties, e.g., interest on acquisition indebtedness, was noted again. Even outside of the circumstance of a holding company operating with respect to more than a single unitary line, it is difficult to determine how to treat interest. For example, assume an existing holding company that wants to expand its existing unitary business (software) into a related, but as yet untried, endeavor (general entertainment). If the holding company incurs indebtedness to acquire an entertainment company that will take years to integrate into the unitary software business, how is the interest expense allocated? Possible approaches include treating money as fungible and apportioning the interest on some recognizable standard for determining borrowing capacity or, alternatively, tracing the interest to the actual transactions that gave rise to the indebtedness.
4. *Real issue pertains to factors.* The proponents of divvying-up noted that in their assessment, the real issue with respect to a holding company operating with respect to more than one line of unitary business is over proper calculation of the factors, because there is intercompany elimination as to transactions occurring between the affiliated companies in their unitary capacities.

VII. **Unity of ownership:** A participant once again noted his simpler approach to defining unity of ownership than is reflected in super-complex California § 25105 and the legal ruling interpreting that statute. This participant urged that unity of ownership leave the control issue entirely alone. The justification for this approach is that unitary of ownership only fulfills a fairness rule of being able to attribute the income of an affiliated company to another affiliate or an affiliated group acting in concert. The participant explained that control is an element for determining whether there is a unitary relationship at all, not whether there is unity of ownership. So the rule as would be stated by this participant was, “Unity of ownership exists if there is direct or indirect ownership of more than 50% of the voting stock of the business entity by another entity or a group acting in concert.” The Task Force was not prepared to embrace the initiative described above at this teleconference but committed to reflecting on the proposal once armed with § 25105 (supplied with the minutes of the earlier teleconference of 07/10/97) and the Legal Ruling 91-1 that is attached to these minutes. The foregoing was developed by a dialogue that included the following observations—

1. *Illustrating the proposed rule.* Assume a company that holds more than 50% of the voting stock of subsidiaries A, B, C, and D. The company and the subsidiaries are in a unitary relationship with one another as defined by the normal rules of the three factors test, the three unities test, or the contribution/dependency test. The company has entered into a voting trust with respect to the voting stock that it holds in D with the minority shareholder of D so that the minority shareholder actually controls D. Under the proposed unitary of ownership rule, the

Company and subsidiaries A, B, C, and D would nonetheless be a unitary business.

2. *Turning our backs on the genius of the Bar.* California § 25105 was the genius of the California Bar. Before we choose to abandon this expert expression we should clearly have our wits about us. [*Ed. Note:* This expresses to hopefully mutual comic effect the sentiment, if not the actual words, spoken on this point.]
3. *The mouse that roared.* One participant from a State having a size no where approaching that of California noted his Supreme Court's advisory opinion that rejected being able to use a flat more than 50% of the voting stock rule to determine unity of ownership. Others noted that this was significant deviation from normal jurisprudential understandings in this area.
4. *Douglas Furniture Instructs.* The noting of *Douglas Furniture* out of California brought about the recognition at least at this meeting of the Task Force of the need to incorporate the "group acting in concert" concept into the proposed statement of the unity of ownership rule. Another indicated, to paraphrase former Governor King of New Mexico, that once you started accounting for special exceptions like *Douglas Furniture* a bunch of pandoras carrying boxes might be released.

VIII. **Pass-through entities:** A participant recommended consideration of California's approach to the apportionment of income of a unitary partnership. The Task Force does not intend undertake a comprehensive examination of the unitary business principle as applied to other types of pass-through entities. In response to the valid observation that the Task Force had hardly discussed the California approach to apportioning the income of a unitary partnership, the direction was given that persons should study the California approach in Cal. Reg. §25137-1, a copy of which is attached to these minutes. At the next meeting of the Task Force where consideration of the California approach can be undertaken, anyone with objections to adopting the California approach is requested to specify the basis of the objection. For now as a clear warning to Task Force members, there seems to be some momentum to adopt the California approach to apportioning the income of a unitary partnership. This momentum caught one participant off-guard when the members noted that the California approach may suggest that a limited partnership interest indicates a non-unitary partnership relationship.

IX. **Future Meeting.** The next meeting of the Task Force is with the full PPWG in Whitefish, MT, on August 6, 1997, from 8:30am to Noon, with some possibility that the individual Task Forces may meet in the afternoon of the 6th from 1:00pm to 4:00pm.